

ECONOMIC OUTLOOK

The national and California economies were growing slowly as 2002 came to a close. Labor markets were weak in California and most of the rest of the nation, and the state and national economies were experiencing jobless recoveries. Better had been expected from both economies at mid-year. Their recoveries are now projected to be sluggish through most of 2003, and economic growth in 2004 will be less robust than had been expected.

The national economy moved into the fourth quarter with a string of four consecutive quarters of increasing output but fewer jobs than when the string began. Consumers pulled back as the quarter proceeded, perhaps from concern about disappointing labor markets or the growing possibility of war, or perhaps from fatigue. As year-end neared, hopes for a strong holiday spending season faded.

California experienced modest job growth and good personal income growth in the first half of 2002, but the budding recovery stalled in the second half with employment falling. Exports of state-made merchandise continued to be down sharply in the third quarter. As the year drew to a close, the

state's important high-tech sector was still struggling. The recovery of the California economy awaits an improved national economy.

The Nation— Jobless Recovery

The national economy is growing slowly and unevenly. Although economic output increased in every quarter from the fourth quarter of 2001 to the third quarter of 2002, labor markets remain weak. In addition, several economic indicators have recently turned negative.

The four quarters of growing output beginning in the fourth quarter of 2001 added up to a gain of just slightly more than 3 percent. In the nine previous recoveries since the end of World War II, economic growth averaged 6.2 percent over the first four quarters of a recovery. Only in the 1991-92 recovery was output growth slower than 3 percent.

The current recovery was expected to be slow at first because the recession had been mild. Instead of cutting back, as they



typically do, consumers spent freely during the downturn. In addition, home sales remained strong, and home values appreciated considerably as interest rates fell to very low levels. As such, consumer spending and residential construction could not have been expected to provide their usual strong boost to the economy when it began to recover.

Slow recoveries delay improvement in labor markets. At the end of the recent four quarters of economic growth, nonfarm payroll employment was about 1.0 percent lower (Figure ECON-1). In the earlier post-World War II recoveries, nonfarm payroll employment grew 2.6 percent, on average, in the first four quarters. The only one in which employment fell was the 1991-92 recovery. Fittingly, the current recovery, like its predecessor, has been widely referred to as a “jobless recovery.” This moniker might be even more fitting today. Extremely strong productivity growth over the recent four

quarters allowed both economic growth and job cuts to be somewhat greater than in the first four quarters of the 1991-92 recovery.

While labor markets were expected to recover slowly, the sharp jump in unemployment to 6 percent and the loss of 40,000 payroll jobs in November really drove home the point. Other recent economic data have also raised concerns. Output from the nation’s factory sector fell from August through October, likely pulling fourth-quarter manufacturing output below the third-quarter level.

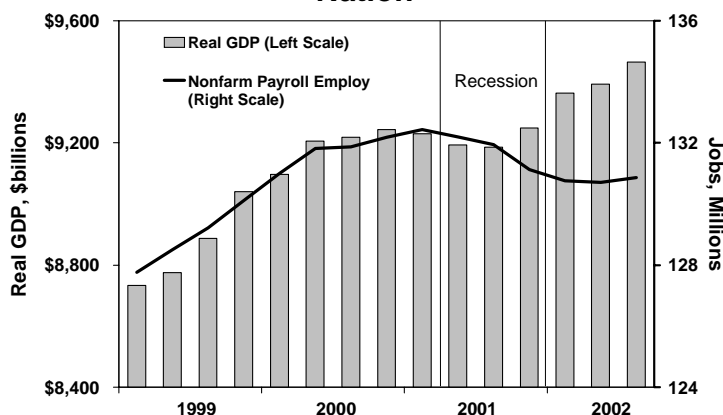
Even more worrisome were signs of consumer fatigue. New light vehicle sales plunged in September from the torrid pace set in July and August. The slowdown in vehicle sales was instrumental in pulling total September retail sales below the third quarter average, providing a poor starting point for fourth quarter sales. Furthermore, retail sales were flat in October.

Weak stock markets, corporate accounting scandals, disappointing labor markets, terrorist threats, and risks of war have taken their toll on consumers’ morale. In the October surveys of consumer attitudes, both the Conference Board and the University of Michigan indices recorded their lowest values in about nine years. A stock market rally lifted consumers’ spirits a bit in November and early December, but overall, consumers were far from upbeat as the all-important Christmas selling season neared.

The consumer’s mood will be closely watched in 2003. Some deceleration in consumer spending is expected, given how long it has held up. A sharp retrenchment, however, would end the recovery, and that is

FIGURE ECON-1

Jobless Recovery Nation



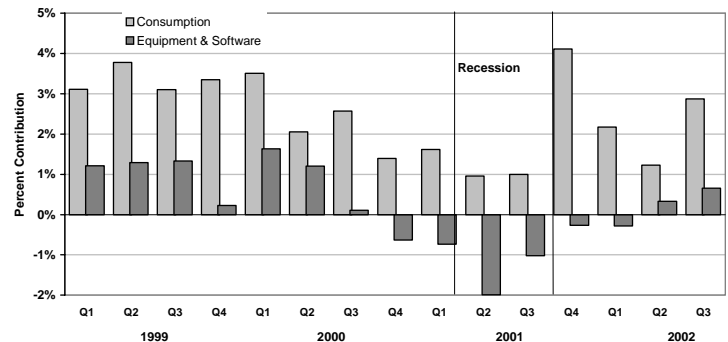
the major risk to the outlook. As recently as the third quarter, special incentives on light vehicles helped consumer expenditures grow at an annual rate of 4.2 percent. However, lower consumer confidence and the apparent satiation of demand for new light vehicles tempered consumer spending considerably in the fourth quarter. In fact, consumer spending may well have declined in the fourth quarter. If so, it was the first decline since 1993.

Other sectors need to take some of the load off of consumers in 2003 to sustain the recovery. There are some positive signs. Capital equipment spending and inventory investment have ended their dramatic declines that began at the end of 2000. The three quarters of declining national output in 2001 were almost entirely due to lower investment spending, in sharp contrast to the typical post-World War II recession characterized by lower consumption spending followed by reduced investment in inventories, capital equipment, and commercial structures. The mere stabilization of capital equipment spending and inventory levels over the last year allowed economic output to grow over the last four quarters (Figure ECON-2).

Spending on capital equipment and inventory investment should add to economic growth in 2003, but investment in commercial structures will take longer to recover. Improvement will be slow at first, and investment will not reach its previous cyclical high, achieved in 2000, until 2004. Investment in computers is growing rapidly in inflation-adjusted dollars, but nominal spending on computer equipment may not reach 2000 levels until 2005. Since employ-

FIGURE ECON-2

Contribution to GDP Growth



ment in the sector is dependent on nominal spending, high-tech employment and revenue will recover slowly.

Robust federal government spending is also contributing to the recovery. The war on terrorism, homeland security, and increased military preparedness for possible war with Iraq are adding considerably to government purchases. Total government expenditures were up by about 4 percent in 2002. That level of growth will be hard to repeat in 2003, given the budgetary shortfalls of State and local governments in much of the nation. Still, a new federal fiscal stimulus package is looking increasingly likely, and that could offset some of the slowdown in State and local government spending.

Low interest rates, federal tax cuts, increases in government spending, and continued, if somewhat more modest, gains in consumer spending will provide enough stimulus to keep the recovery going in 2003. In many industries, excess capacity will keep firms from adopting generous capital equipment spending plans. Excess capacity, both domestically and abroad, will also keep inflation low.



Growth will be modest during the first half of 2003. Firms will squeeze as much output from their current workers as possible, resulting in negligible employment gains. By the end of next year, however, they will find it necessary to increase hiring in order to meet increased production schedules.

With the memory of corporate scandals fading and profits improving, equity markets rallied in both October and November. Before-tax corporate profits increased in the first two quarters of 2002. The last two quarters of 2002 likely brought further profit gains. A steady improvement in profitability over the forecast horizon will produce double-digit year-over-year profit growth for both 2003 and 2004. Continued low interest rates and higher profits will add up to a much-improved environment for equity markets.

The major risk to the outlook is a significant retrenchment by consumers. Consumers have spent aggressively for many years, and their debt loads have increased considerably. Further, their confidence has waned somewhat as the stock market continues to disappoint and the prospects of war with Iraq remain real. On the other hand, interest rates are very low, and many homeowners are sitting on a considerable amount of home equity.

The primary development that could boost the economy beyond expectations is a significant new federal fiscal stimulus package made up of well-designed, effective tax breaks and targeted increases in government spending. Eliminating the double taxation of dividend income or lowering capital gains tax rates would provide little stimulus to the economy. A new package is

not incorporated in the forecast because a specific proposal has not been put forth, let alone been debated in Congress.

California—Mirroring the National Economy

Like the nation, California is experiencing a jobless recovery. The state economy improved in the first half of 2002, with employment and total state personal income posting gains. The improvement faltered at mid-year, however. The state lost jobs between June and November, and personal income likely fell in the third quarter (Figure ECON-3). In addition, unemployment failed to improve, as the rate varied between 6.4 percent and 6.5 percent from March to November.

Employment grew by about 4,600 jobs per month, on average, in the first 11 months of 2002—a meager amount, but a big improvement over an average monthly loss of 16,100 jobs in 2001. Instrumental in that swing were sharp drops in the rate of job losses in business services and high-tech manufacturing; improved job growth in retail trade, particularly at eating and drinking establishments; and a swing from job losses to job gains in wholesale trade. Employment growth deteriorated in some industries, however. Construction and depository institutions trimmed payrolls in 2002 after expanding them in 2001. Local government and social services added fewer jobs in 2002 than in 2001. And employment in State government, outside of education, fell in 2002.



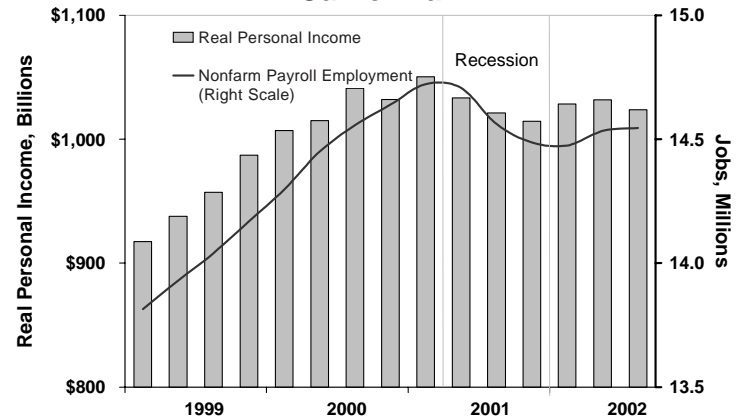
California's recession was highly concentrated both regionally and industrially. Job losses, net of job gains, in the San Francisco Bay Area—almost all of which were in the San Francisco and San Jose metropolitan areas—greatly exceeded net job losses in the entire state. That is, the rest of the state experienced a net job gain, in total, during the recession. By one measure, the low point for the Bay Area was March 2002, when the number of nonfarm payroll jobs was 4.0 percent lower than a year earlier. In contrast, jobs were 0.5 percent above a year ago in Southern California. The gap in year-over-year job growth between the two regions narrowed considerably, however, as the year progressed. Job losses shrank appreciably in the Bay Area; and by November, nonfarm payroll jobs were only 1.6 percent lower than a year earlier. In Southern California, job gains remained largely unchanged, with nonfarm payroll jobs up 0.4 percent from a year earlier.

No less striking was that three out of every five jobs lost during the recession were in high-tech services and manufacturing. Workers in some high-tech industries were particularly hard hit. One out of every five jobs was lost in communications equipment manufacturing, electronic components and accessories manufacturing, and computer and data processing services. Two out of every five jobs were lost in the information retrieval industry—a sector of computer and data processing services that includes most of the Internet companies.

Unemployment rates around the state painted a consistent picture. The San Jose metropolitan area went from having the lowest unemployment rate of the major California metropolitan areas before the

FIGURE ECON-3

Jobless Recovery California



recession to having one of the highest unemployment rates after the recession. The swing was not as great for the San Francisco metropolitan area, but after having the second lowest unemployment rate before the recession, its rate more than doubled by the end of the recession. Orange and San Diego Counties, on the other hand, had among the lowest unemployment rates before the recession and the two lowest unemployment rates after the recession.

Gains in state personal income in the first two quarters of 2002 suggest that state economic output grew in the first half of 2002. These gains were a welcome development coming after three consecutive quarterly declines. While the job losses during the recession were about average for a post-World War II recession, the decline in personal income, when adjusted for inflation, was second only to the decline in the long and deep 1990-1993 recession. The wide disparity between job losses and decline in personal income in the recent



recession was due to the sharp decline in employee bonus and stock option income brought about by the collapse of the stock market.

Given how modest the recovery has been so far, California housing markets were surprisingly strong in 2002. In the first 10 months of 2002, sales of existing, single-family homes were up 13 percent from a year earlier, according to the California Association of Realtors. The year-over-year increase in the median price of these homes ranged from 17 percent to 25 percent over the 10 months. The median price breeched \$300,000 for the first time in March; by October, it was \$334,000. Extremely low mortgage rates were instrumental in this high level of activity and price appreciation and, most likely, a concurrent pick-up in building. The number of permits for residential units exceeded year-earlier levels by 11 percent in the first 10 months of the year.

Commercial real estate markets did not fare as well. Nonresidential construction fell sharply for the second consecutive year in 2002. Office vacancy increased in most California metropolitan areas in the third quarter of 2002, both from quarter-ago levels and year-ago levels. The San Jose and San Francisco metropolitan areas stood out for having office vacancy rates considerably above the national average for metropolitan areas. San Jose also had the largest increase in office vacancy in the third quarter of the 50 markets surveyed by CB Richard Ellis. Sacramento and San Diego shone, however, with office vacancy rates among the lowest in the nation. Industrial vacancy was less of a problem despite vacancy being slightly above the national

average in San Francisco and considerably above the national average in Sacramento in the third quarter. Vacancy rates in San Diego and Los Angeles were well below the national average even after San Diego's sizable gain in vacancy in the third quarter.

Declining exports of California-made merchandise contributed to the state economy's sluggishness in 2002. Exports were 16 percent below year-earlier levels in the first three quarters. A precipitous drop in exports to Japan accounted for 24 percent of the total decline in state exports (Figure ECON-4). Lower exports to Canada, the United Kingdom, Germany, and Singapore accounted for another 36 percent of the overall drop. Exports to Mexico, the leading destination for California-made merchandise, held up relatively well, slipping only 2 percent.

More is at work in California's export slide than weak economies of major trading partners. While the German and Japanese economies are among the weakest of the major developed economies, the Canadian economy is doing very well, and the economies of the United Kingdom and Singapore are quite strong. The worldwide high-tech recession has been a bigger factor in California's sagging exports. Computer and electronic products, which made up 44 percent of the state's exports in the first three quarters of 2002, accounted for two thirds of the overall decline in exports.

One of California's largest services exports—tourism—has yet to recover to pre-September 11 levels. The “drive-to” markets, like San Diego, are doing quite well, but “fly-to” markets that depend on out-of-state and foreign visitors continue to



struggle. More intensive airport security checks appear to have convinced some vacationers to stay closer to home. In addition, the recession has cut business travel, especially to the state's high-tech centers. Hotel and motel occupancy rates have come only part of the way back to pre-September 11 levels, and average room rates remain considerably below year-ago levels in many markets.

The California economy entered 2003 with little momentum. The state's fledgling recovery faltered in the second half of 2002. Labor markets are weak with no signs that significant improvement is imminent. The state economy appears to be tracking the national economy quite closely as it has for most of the post-World War II period, with the notable exception of the first half of the 1990s, when a sharp contraction of the state's aerospace sector helped push the state economy into a long, steep decline. The outlook for the California economy in 2003 depends heavily on the fate of the national economy. Near-historic low interest rates should help the state economy in 2003, as should continued strong spending on national defense and homeland security. Federal fiscal stimulus will be even stronger if the nation goes to war with Iraq. On balance, the outlook for the California economy is for slow growth in 2003 and moderate growth in 2004 (Figure ECON-5). Unemployment will likely increase somewhat in 2003 before falling in 2004. Personal income will grow in 2003 and 2004, but not as quickly as in past recoveries. The main risk from the outlook for the state economy is the same as that for the na-

tional economy—a retrenchment by consumers. In addition, the state is more at risk from a delay in the high-tech recovery.

FIGURE ECON-4

Growth in Exports to Top California Markets
First Three Quarters: 2001 to 2002

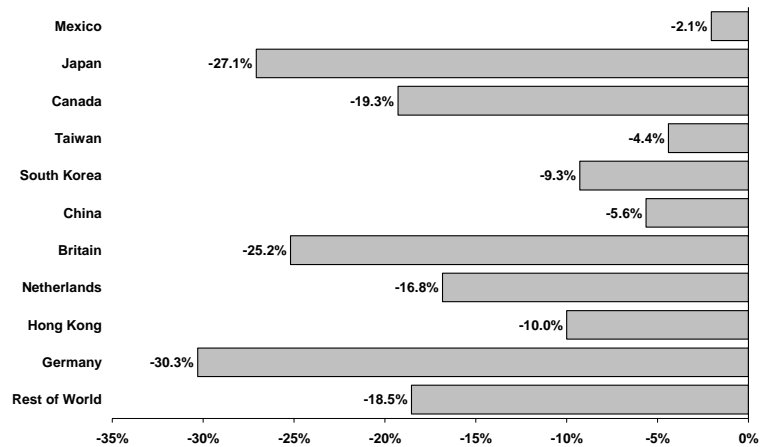


FIGURE ECON-5

Selected Economic Data for 2002, 2003, and 2004

| United States | 2002 | Forecast | |
|---|-----------|-----------|-----------|
| | | 2003 | 2004 |
| Real gross domestic product (1996 dollar, percent change) | 2.3 | 2.5 | 3.5 |
| Personal consumption expenditures | 2.9 | 2.1 | 3.0 |
| Gross private domestic investment | 0.7 | 3.5 | 7.3 |
| Government purchases of goods and services | 4.2 | 2.6 | 1.6 |
| GDP deflator (1996=100, percent change) | 1.2 | 2.0 | 2.3 |
| GDP (current dollar, percent change) | 3.5 | 4.6 | 5.9 |
| Federal funds rate (percent) | 1.67 | 1.49 | 3.27 |
| Personal income (percent change) | 3.0 | 4.1 | 5.4 |
| Corporate profits before taxes (percent change) | -0.9 | 15.2 | 9.3 |
| Nonfarm wage and salary employment (millions) | 130.8 | 132.0 | 134.8 |
| (percent change) | -0.8 | 0.9 | 2.1 |
| Unemployment rate (percent) | 5.8 | 6.0 | 5.5 |
| Housing starts (millions) | 1.69 | 1.57 | 1.66 |
| (percent change) | 5.4 | -6.9 | 5.4 |
| New car sales (millions) | 8.0 | 7.7 | 7.3 |
| (percent change) | -4.8 | -4.4 | -4.8 |
| Consumer price index (1982-84=100) | 179.9 | 184.5 | 188.9 |
| (percent change) | 1.6 | 2.5 | 2.4 |
| California | | | |
| Civilian labor force (thousands) | 17,576 | 17,715 | 18,014 |
| (percent change) | 1.2 | 0.8 | 1.7 |
| Civilian employment (thousands) | 16,443 | 16,560 | 16,894 |
| (percent change) | 0.1 | 0.7 | 2.0 |
| Unemployment (thousands) | 1,133 | 1,155 | 1,120 |
| (percent change) | 22.1 | 1.9 | -3.0 |
| Unemployment rate (percent) | 6.4 | 6.5 | 6.2 |
| Nonfarm wage and salary employment (thousands) | 14,521 | 14,623 | 14,928 |
| (percent change) | -0.7 | 0.7 | 2.1 |
| Personal income (billions) | \$1,138.7 | \$1,176.0 | \$1,238.4 |
| (percent change) | 0.9 | 3.3 | 5.3 |
| Housing units authorized (thousands) | 159 | 157 | 162 |
| (percent change) | 6.5 | -1.3 | 3.2 |
| Corporate profits before taxes (billions) | \$91.8 | \$99.9 | \$109.6 |
| (percent change) | -0.3 | 8.9 | 9.7 |
| New auto registrations (thousands) | 1,722 | 1,733 | 1,723 |
| (percent change) | -2.3 | 0.6 | -0.6 |
| Total taxable sales (billions) | \$432.0 | \$447.0 | \$472.0 |
| (percent change) | -2.2 | 3.4 | 5.6 |
| Consumer price index (1982-84=100) | 186.2 | 191.5 | 197.6 |
| (percent change) | 2.5 | 2.8 | 3.2 |

Note: Percentage changes calculated from unrounded data.

